No. 14623

In the United States Court of Appeals for the Ninth Circuit

FORREST L. MOE AND EDITH B. MOE, APPELLANTS

v.

HUGH H. EARLE, FORMER COLLECTOR OF INTERNAL REVENUE AT PORTLAND, OREGON, APPELLEE

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF OREGON

BRIEF FOR THE APPELLEE

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INDEX

CITATIONS

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OPINION BELOW

The findings of fact and conclusions of law of the District Court (R. 52-71) are not officially reported.

JURISDICTION

This appeal involves income taxes in the amount of $173.44 plus interest for the years 1949 and 1951 (R. 7, 11) which taxpayer [1] paid with his income tax returns for those years (R. 66, 69). Taxpayer filed timely claims for refund. (Exs. 29 and 30; R. 68, 70.) The

[1] For convenience Forrest L. Moe will be referred to as the taxpayer, although he and his wife Edith B. Moe filed joint income tax returns for the taxable years. (Exs. 26 and 28.)

Commissioner of Internal Revenue did not act on the claims for refund within six months after filing, and taxpayer's complaint in this action was filed in the District Court for the District of Oregon on July 17, 1953, more than six months after the filing of the claims for refund, and within the time provided in Section 3772 of the Internal Revenue Code of 1939, against the Collector for refund of amounts which had been allegedly included erroneously in the returns. (R. 3-21.) Jurisdiction was conferred on the District Court by 28 U.S.C., Sec. 1340. Judgment was entered in favor of the Collector on October 12, 1954. (R. 72-73.) Within 60 days and on November 10, 1954, taxpayer filed notice of appeal. (R. 73-74.) Jurisdiction is conferred on this Court by 28 U.S.C., Sec. 1291.

QUESTION PRESENTED

In 1942 a cooperative marketing association issued and delivered to taxpayer certificates of contribution to its revolving capital fund on account of payments he had made in prior years for which no certificates had been issued. Did the District Court err in holding that taxpayer did not erroneously include in his income tax returns for 1949 and 1951 cash amounts received by him in those years from the association upon surrender for cancellation of these certificates of contribution?

STATUTE INVOLVED

Internal Revenue Code of 1939:

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal serv-

ice, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

*   *   *   *   *

(26 U.S.C. 1952 ed., Sec. 22.)

STATEMENT

The facts as contained in the findings of fact of the District Court (R. 55-70) may be summarized as follows:

Taxpayer is engaged in the business of growing and selling fruit in Oregon, and became a member of the Apple Growers Association of Hood River, Oregon, and a party to that Association's Standard Co-Operative Growers Contract on December 9, 1929. The Association is a corporation operating as a nonprofit agricultural cooperative association of fruit growers with United States income tax exempt status under Section 101(12) of the Internal Revenue Code. (R. 55-56.)

A members' bylaw of the Association adopted in 1920, in effect when taxpayer became a member of the cooperative and until June 1, 1940, provided for a "Building and Equipment Fund" charge as follows (Ex. 14, pp. 32-33, R. 56-57):

> Section 7. Building and Equipment Fund. There is hereby created a permanent fund of an amount

equal to from nothing to five cents per package per annum on all fruit handled by the Apple Growers Association, commencing with the fiscal year beginning June 1st, 1919, of the standard grades of fruit on which the Association's handling and marketing charges, at the time this amendment was adopted, were ten cents per package, and a pro rata amount on all packages of fruit on which the Association's handling and marketing charges were more or less than ten cents per package, at the time this amendment was adopted.

Said fund so created, shall be known as the "building and equipment fund," and shall be kept separate and apart from all other funds and moneys of the Association and shall be used exclusively for the purchasing of or paying for property, equipment or betterments, for the benefit of the members of the Association in handling and marketing their fruit, and no portion of said fund shall be paid out in any other manner or for any other purpose than as stated herein.

The amount raised in any fiscal year for such "building and equipment fund," shall be, in the discretion of the board of directors; provided, however, the amount raised for such fund shall not exceed in any fiscal year an amount equal to five cents per standard package of the fruit handled by the Association during such fiscal year.

The fruit delivered by the taxpayer to the Association during each of the years pertinent to this action was pooled by the Association with fruit of similar variety, size and other classifications, delivered by other growers. Upon disposal by the Association of

all fruit in a particular pool, that pool was "closed," and the Association recorded on a "Pool Closing Recap" sheet covering that pool the number of boxes of each grade and size included in that pool, and the price per box and total amount received therefor by the Association. Also recorded on the Pool Closing Recap were the rates and amounts of the Association's operating charges applicable to the fruit in that pool, and the rate and amount of the Building and Equipment Fund deduction applicable to that fruit. These deductions were debited, on the Pool Closing Recap, against the gross receipts by the Association shown thereon, and the "net credit" to the growers having fruit in that pool was thus determined and stated on the Recap sheet. Representative of such Pool Closing Recap Sheets is Exhibit 31. (R. 57-58.)

After the closing of each such pool in which the taxpayer had fruit, and the preparation of the aforesaid Pool Closing Recap for that pool, the Association prepared and delivered to the taxpayer, in accordance with its normal procedure as to all grower-members, a written "Pool Closing Statement" covering the taxpayer's fruit in that pool. Each of such statements to the taxpayer was on the same printed form as was used by the Association for its Pool Closing Recaps (Ex. 31) and set forth the same data as to the taxpayer's fruit as was set forth on the Pool Closing Recap as to all growers, i.e.: the number of boxes of each grade and size which the taxpayer had in that pool, the price per box and total amount received therefor by the Association, the rates and amounts of the Association's operating charges applicable to that fruit, and the rate and amount of the per-box Building and Equipment Fund deduction against the taxpayer.

These deductions were debited, on each of taxpayer's Pool Closing Statements, against the gross receipts of the Association shown thereon, and the "net credit" to the taxpayer from that pool was thus computed and stated on the Statement. No original or copy of any of the Pool Closing Statements to the taxpayer is now available, as the taxpayer some years ago destroyed his originals, and the Association destroyed its carbon copies in accordance with its general practice to keep such records seven years only. Along with each Pool Closing Statement the taxpayer received cash payment or credit by the Association of the amount of the net credit shown by that statement, being the sales prices received by the Association for the fruit covered by that statement, less the Association's operating charges, and less the per-box deduction for the Building and Equipment Fund. (R. 58-59.)

The total amount of the Building and Equipment Fund deductions calculated, according to the above by-law as to the taxpayer during each of the years pertinent to this action, and entered on the taxpayer's Pool Closing Statements are as follows (R. 59-60):

For Association's Fiscal Year	Amount	Year Charged to Taxpayer on Pool Closing Statements
1929–30	$140.46	1930
1930–31	$261.48	1931
1934–35	$ 78.76	1935
1935–36	$116.99	1936
1936–37	$100.25	1937

Upon the closing of all pools for each of the fiscal years, the respective one of the total amounts was recorded and credited to the taxpayer on the Association's records. (Exs. 5 and 6; R. 59-60.)

On August 10, 1940, Article X of the Members' By-laws of the Apple Growers Association was amended

by adding thereto the following provisions (Ex. 14, pp. 11-15):

Section 9. Revolving Capital Fund, Budget, Certificates of Contribution, etc.

(a) Revolving Capital Fund, Limitation of Retains. The creation of a "revolving capital fund" of the Apple Growers Association, commencing with the fiscal year beginning June 1, 1940, is authorized in such an amount as in the judgment of the board of directors may be required, from time to time, to purchase and acquire real and personal property, to establish and maintain reserve funds and sinking funds, and for any proper capital purpose of an association in conducting its business properly, efficiently and economically when operating as a farmers' co-operative in purchasing supplies, and in handling, storing, processing and marketing orchard and farm products for its members; and which shall be in addition to and separate from the funds provided for in the "tentative operating budget" in Sections 1, 2 and 3, of said Article X of said Members' By-laws; but not exceeding the needs of the Association. Said "revolving capital fund" shall be created and maintained by existing funds, as hereinafter mentioned, and by the Association's withholding from the proceeds of sale of fruit and products handled by it of a percentage thereof to be determined by the board of directors. The amount so withheld each year shall be known as "contributions," and shall not exceed what would be the total of 5 cents per standard box for all apples, pears, cherries and strawberries, and 5 cents per

standard case or proportionate quantity, for all processed products handled by the Association during that year.

(b) Capital Fund Budget. During the month of July each year the board of directors shall cause a tentative capital fund budget to be prepared showing the percentage of proceeds and the total estimated amount thereof to be withheld as "contributions" to the "revolving capital fund" for that fiscal year, both divided into accounts conforming to the purposes stated in subdivision (a) of this Section 9, and clearly showing the amount and purpose of each account. A copy of said tentative capital fund budget shall be then mailed to each member. Said tentative capital fund budget may be amended by a two-thirds majority vote of all members present at their first meeting thereafter, but not later than during the month of August that year. The tentative capital fund budget shall be considered as approved and adopted by the members unless same shall be so amended. The budget as so prepared, or as so prepared and amended, shall be final and the basis for the retention of "contributions" for the fiscal year.

(c) Deductions For Other Capital Funds Discontinued. No further deductions shall be made or "contributions" required under the provisions of Section 7 of said Article X, providing for what is known as the "building and equipment fund"; or under the provisions of Sections 4, 5 and 6 of said Article X of the Members' By-laws, providing for what is known as the "purchasing fund"; or under the provisions of Section 8 and subdivisions (a) to (f) thereof, inclusive, adopted by the mem-

bers April 3, 1937, providing for what is known as the "revolving purchasing fund."

(d) Said portions of said Members' By-laws last above mentioned are not repealed or amended except as hereinafter provided, and nothing herein contained shall be construed as depriving any member or person of any right acquired under any of the said by-laws provisions. The funds accumulated under the said sections and subdivisions of sections of said by-laws, shall continue to be managed and used for the respective purposes provided for therein until same shall be refunded, as provided for herein. It is the intention to cause said "revolving purchasing fund" to operate and to be refunded hereunder in the same manner as provided for by the said Section 8 and subdivisions thereof adopted April 3, 1937.

(e) Administration of Revolving Capital Fund. The board of directors shall cause the following named funds, to-wit:

(I) "Purchasing Fund"
(II) "Revolving Purchasing Fund"
(III) "Membership Fee Fund" and "Building and Equipment Fund," and
(IV) "Revolving Capital Fund"

to be refunded to members in the above order in such an amount each year as in its judgment the best interests of the Association and its members may warrant, if any; but not exceeding for any fiscal year the amount of "contributions" received that fiscal year to the "revolving capital fund" hereby authorized; no refund shall be made to one who has canceled, terminated or forfeited the

standard growers contract or any renewal or continuation of any such contract which shall have been assigned in accord with the Members' By-laws, under which "contributions" were retained and accumulated. Subject to the above provisions for the order of refunding, the amount of each refund shall be prorated to the growers who contributed the earliest unrefunded "contributions" and no refund shall be made for any year until all "contributions" withheld during all prior years shall have been refunded in full or made payable by the board upon presentation of "contribution certificates" as herein provided.

(f) In creating, managing and refunding said "revolving capital fund" the board of directors shall have full discretion subject only to the provisions hereof.

(g) Expenditures from said "revolving capital fund" shall be made for capital investments and purposes and not for other purposes such as operating expenses and losses, etc. Said "revolving capital fund," or any portion thereof, shall not be paid out as a dividend or considered as, or be a part of any surplus in declaring a dividend, except by way of refunding, as herein provided.

(h) Certificates of Contribution. There shall be issued at the end of each fiscal year to each member who may have contributed to said "revolving capital fund," a certificate or certificates in form in accord herewith showing the net amount of his "contributions" and the year or years for which the "contributions" were withheld. Said certificates shall not be evidence of any debt, shall not bear interest, shall give no voting rights, shall be-

come null and void if the membership under which the "contributions" were made shall be canceled, terminated or forfeited, and shall not be negotiable or assignable except to the purchaser of the membership under which the "contributions" were made, together with a sale and conveyance of the premises to which the membership pertains and then only by consent of the board of directors and subject to any unpaid debt or obligation of the assignor. Nothing herein contained shall be construed as preventing title in such certificates passing by will or inheritance. The amount of said certificates may be paid in full or in part at any time, subject to the provisions hereof. Full payment shall be made only upon surrender of the certificates for cancellation. Part payment shall be made only upon presentation of certificates for endorsement of the payment thereon. Certificates issued under Section 8, adopted by the members April 3, 1937, shall be honored and paid under the provisions thereof. For convenience and administration purposes, the whole of the said various funds to be handled subject to the provisions hereof, may be called or known as parts of the "revolving capital fund."

On November 21, 1942, the Apple Growers Association issued and delivered to taxpayer "Certificates of Contribution to the Revolving Capital Fund," as follows (R. 65):

Certificate No.	Series	Fiscal Year of Contribution	Amount	
326	1929	1929–1930	$140.46	(Exhibit 8)
326	1930	1930–1931	$261.48	(Exhibit 9)
300	1934	1934–1935	$ 78.76	(Exhibit 10)
301	1935	1935–1936	$116.99	(Exhibit 11)
284	1936	1936–1937	$100.25	(Exhibit 12)

On April 7, 1949, the following resolution was adopted by the board of directors of Apple Growers Association (Ex. 23, R. 65-66):

> That the 1929 and 1930 contributions to the Revolving Capital Fund be authorized for payment to members in good standing. Such payment of approximately $100,000.00 to be made by the Treasurer as soon as necessary clerical work can be completed.

Pursuant to the foregoing resolution and bylaws, the Apple Growers Association on or about May 2, 1949, paid the sum of $401.94, being the aggregate of the amounts stated on the two Certificates of Contribution to the Revolving Capital Fund No. 326, Series of 1929 and 1930, and the taxpayer surrendered the two certificates to the Association. (R. 65-66.)

Taxpayer did not include in any income tax return for a year prior to 1949 sums deducted against and credited to him by the Association for the Building and Equipment Fund nor any sum represented by the Certificates of Contribution to the Revolving Capital Fund, No. 326, Series of 1929 and 1930. (R. 67-68.)

On March 23, 1951, the following resolution (Ex. 24) was adopted by the board of directors of Apple Growers Association (R. 68):

> That the 1934, 1935 and 1936 Revolving Capital Fund contributions be authorized for payment to members in good standing. Such payment of approximately $95,207 to be made by the Treasurer as soon as necessary clerical work can be completed but not later than May 15, 1951.

Pursuant to the foregoing resolution and bylaws, the Apple Growers Association on or about April 25, 1951, paid to taxpayer the sum of $296, being the sum of the amounts stated on the three Certificates of Contribution to Revolving Capital Fund No. 300, Series of 1934; No. 301, Series of 1935, and No. 284, Series of 1936, and taxpayer surrendered each of the certificates to the Association. (R. 68-69.)

Taxpayer did not file with the Collector of Internal Revenue for the District of Oregon any income tax return for any of the years 1930, 1931, 1932, 1934, 1935, 1936 or 1937. Taxpayer did not include in any income tax return for any year prior to the return filed by him for the year 1951 the sums, or any part of the sums, which had been deducted against and credited to the taxpayer by the Apple Growers Association for the Building and Equipment Fund during the fiscal years 1934-35, 1935-1936, and 1936-1937, nor any sum as represented by the three Certificates of Contribution to the Revolving Capital Fund covering those fiscal years (R. 69-70).

On the basis of the foregoing facts, the District Court held that the amounts paid to the taxpayer in cash by the Apple Growers Association in 1949 and 1951 to redeem the "Certificates of Contribution to Revolving Capital Fund of Apple Growers Association—Hood River, Oregon," were income to the taxpayer in the years in which such payments were made and such certificates were redeemed, and that they were not income in the years in which such amounts were deducted from the sums of money payable to the taxpayer for his fruit, or in the year in which such certificates were issued to the taxpayer. (R. 70-71.) It consequently

held there was no error in taxpayer including in his income for 1949 and 1951 cash received in those years from the redemption of Revolving Capital Fund Certificates issued and delivered to him by the Apple Growers Association in 1942, and it dismissed taxpayer's complaint. From the judgment dismissing the complaint (R. 72-73) taxpayer has appealed to this Court (R. 73-74).

SUMMARY OF ARGUMENT

Under the decision of this Court in *Caswell's Estate* v. *Commissioner,* 211 F. 2d 693, taxpayer is not entitled to a refund for income tax paid on patronage dividends reported in 1949 and 1951 when certificates of contribution were redeemed.

ARGUMENT

No Refund Should Be Allowed for the Income Tax Paid on Patronage Dividends Reported in 1949 and 1951 When Certificates of Contribution Were Redeemed.

The sole issue in this case is whether taxpayer is entitled to a refund of income tax attributable to amounts paid by the cooperative to the taxpayer in 1949 and 1951, to redeem Certificates of Contribution to the cooperative's revolving capital fund issued to him in 1942, as receipts for payments taxpayer made in prior years. The taxpayer claims that he constructively received income in the prior years in which he made payments to the fund, but that he permitted the cooperative to apply these amounts on his obligation to the capital fund, without receiving the sums and paying them back again (Br. 11-16); and, therefore, that he erroneously included the amounts in his returns for 1949 and 1951, and should be entitled to a refund for those years.

Under the decision of this Court in *Caswell's Estate* v. *Commissioner,* 211 F. 2d 693, a member cash-basis patron of a cooperative realizes income only at the time of the redemption of patronage certificates, rather than when the amounts are allocated to him on the cooperative's books or at the time the Certificates of Contribution are issued to him. *Commissioner* v. *Carpenter,* 219 F. 2d 635 (C.A. 5th), is to the same effect.

In those cases, as in the present case, the cooperative was under a pre-existing obligation with respect to retained patronage dividends, after using whatever portion was necessary for authorized expenditures, to allocate the net margins remaining to the accounts of the respective patrons and to notify them of such allocation. In this case (after 1920), as in those cases, the board of directors of the cooperative was given discretion under the bylaws to retain amounts it determined necessary for capital purposes of the Building and Equipment Fund, up to a specified maximum sum, out of net proceeds due the patrons, and the patrons had no right to compel the distribution to them of such amounts in cash. (Ex. 14, pp. 32-33.) The case of *Hood River Orchard Co.* v. *Stone,* 97 Ore. 158, 191 Pac. 662, relied on by the taxpayer (Br. 12), is inapplicable since that case involved a cooperative-patron relationship existing prior to the adoption in 1920 of the bylaw authorizing the Building and Equipment Fund. In that case the patron was seeking to recover the balance of the selling price of fruit which it delivered to the cooperative under a contract which gave the association no right to withhold amounts for the creation of a surplus. The holding there was that the patron had not acquiesced in the business methods of the association in regard to creating the surplus.

The District Court's opinion here (R. 52-53, 70-71) is fully in accord with the *Caswell* and *Carpenter* decisions, *supra,* and if this Court should adhere to its previous decision in the *Caswell* case, the District Court should be affirmed.

The substance of the taxpayer's contention in this Court is, we believe, to seek a reconsideration of the *Caswell* decision. We would agree that that decision, as well as the *Carpenter* decision, *supra,* is contrary to long established administrative practice of the Internal Revenue Service and also is inconsistent with the reasoning of certain prior decisions of this and other courts relating to the exemption of certain cooperatives from income tax or to the exclusion of patronage refunds from their income. See I.T. 3208, 1938-2 Cum. Bull. 127; Income Tax Information Release No. 2, dated April 13, 1950 (1950 C.C.H., par. 6111); T.D. 6014, 1953-1 Cum. Bull. 110, 117-118; Rev. Rul. 54-10, 1954-1 Cum. Bull. 24; Senate Hearings on Revenue Act of 1951, Part 2, pp. 1251, 1286, 1419, 1420, 1426, 1428, 1429, 1430 and 1436.

CONCLUSION

If this Court should adhere to its decision in the *Caswell* case, *supra,* the District Court's holding that the redemption of the certificates constituted income to the taxpayer in 1949 and 1951, when the Certificates of Contribution were redeemed, should be affirmed and taxpayer's claim for refund denied.

Respectfully submitted,

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APPENDIX

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-23 [as added by T.D. 6014, 1953-1 Cum. Bull. 110, 117-118]. Allocations by Cooperative Associations; Tax Treatment as to Patrons.—(*a*) *In general.*—Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 101(12)(B), in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner disclosing to the patron the dollar amount allocated shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in (*b*) of this section, regardless of whether the amount allocated is deemed, for the purpose of section 101(12)(B), to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the basis, cash, accrual, or otherwise, upon which the net income for such patron is computed.

(*b*) *Extent of taxability.*—(1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services the cost of which was deductible by the patron under section 23, shall

be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates, or similar documents—

(A) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time required by section 29.101 (12)-4(*a*)(ii).

(B) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as "reasonable reserves" under section 29.101-4(*a*).

(C) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in

(A), above, or from amounts retained as "reasonable reserves" under section 29.101 (12)-4(*a*), referred to in (B), above. Where, in such case, the documents allocated are negotiable instruments, such documents shall be includible in the income of the patron to the extent of their fair market value at the time of their receipt.

*   *   *   *   *

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